Market Commentary

Residential Analysts

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United Kingdom – June 2022

- **Stuck In The Corner**
- **Rapidly Rising Rates & Still Not So Special**
- **Once Every Ten Years**

The housing market is still booming despite higher mortgage rates and the rising cost of living. However, the risks of a slowdown are increasing but the impact of higher mortgage rates will depend on what happens to loan-to-income ratios. It's not just the UK housing market that is facing these challenges, with other high growth markets facing higher rates and slowing prices. Meanwhile, interpreting the 2021 Census is a challenge given its timing.

Stuck In The Corner

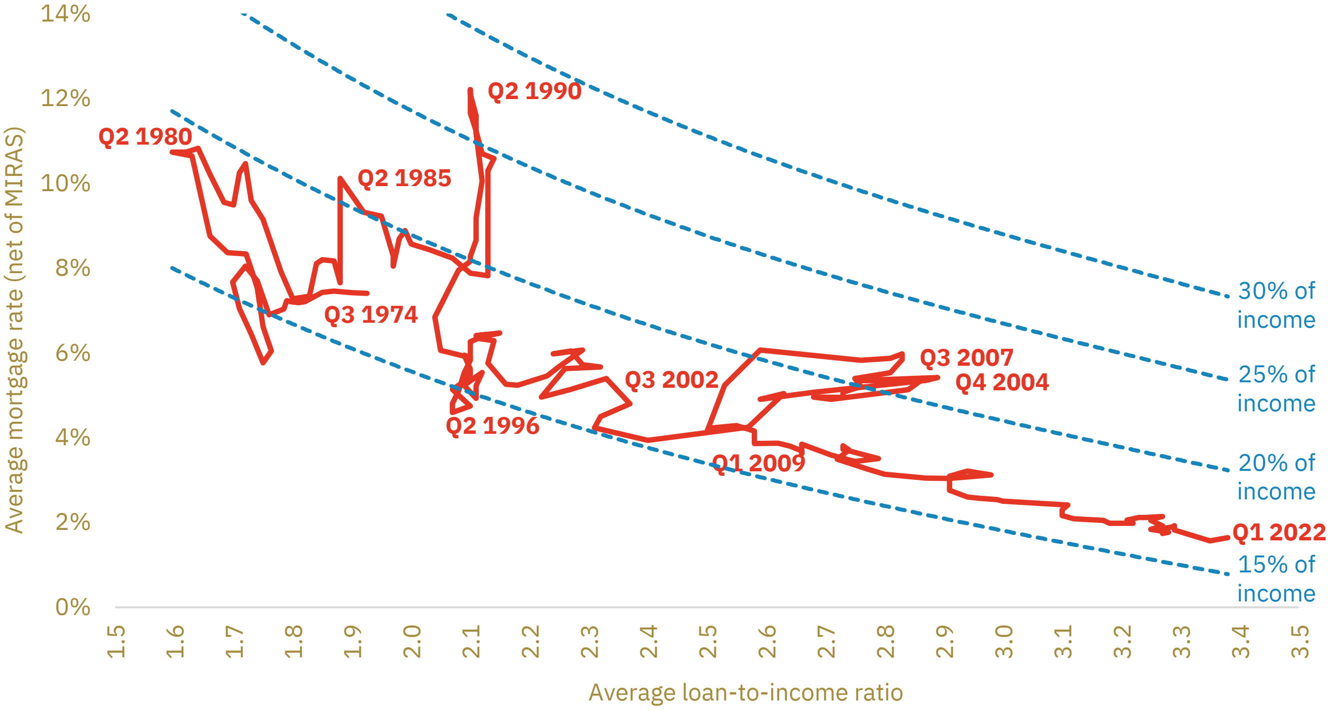
The cost of living is rising and the threat of a recession is growing but the housing market is still booming (and we've been writing a variation of this for several months now). House price indices are still reporting annual price rises of around 10% and most transaction measures are showing activity levels around 10% higher than their pre-pandemic average - though mortgage approvals for house purchase fell back to their previous average in April. Meanwhile, the risk of recession is increasing and the rising cost of living is starting to bite – especially for those on lower incomes. Having passed through a pandemic with a boom in activity and new record high prices, the housing market faces new headwinds – not least the impact of rising mortgage rates.

The housing market in the UK is very sensitive to changes in mortgage rates. Over the last thirty years this has largely been to the benefit of homeowners as interest rates fell lower and lower – enabling them to borrow more while pushing house prices ever upwards. While the recent shift to more longer fixed-rate periods (5 years) will help reduce the immediate impact of any mortgage rate rises on existing borrowers, it is new buyers that will be most immediately affected. Much of the impact will depend on what happens to loan-to-income ratios (LTIs). The LTI is the primary mechanism for home buyers to translate lower rates into higher house prices – if LTIs are fixed then a lower rate just leads to a lower mortgage repayment but, as has happened over the last thirty years and as shown by Figure 1, a lower mortgage rate also enables borrowers to service a higher LTI for the same repayment. The consequence of this is, with mortgage rates near record lows in Q1 2022 and loan-to-income ratios at record highs, we are now potentially stuck in the bottom right-hand corner of Figure 1.

For more information on how to interpret Figure 1, see Neal's 2015 report(PDF) on first time buyer affordability.

Fig 1: Mortgage Repayment Affordability

Source: ONS, Bank of England – repayment lines assume interest and capital repayments with 25 year term



Rapidly Rising Rates

Mortgage rates are rising rapidly though they are yet to have an impact on the housing market. As Figure 2 shows, average quoted rates across all loan-to-value ratios (LTVs) have risen sharply in recent months though the rise has been greatest for those at lower LTVs. The average quoted rate on a 75% LTV mortgage was 2.63% in May- a rate last seen in June 2013 – while rates on higher LTVs are still below the highs recorded during the 2020/21 credit crunch. Despite these rising mortgage rates, they are yet to have an effect on the market as the majority of transactions currently in progress will involve buyers that have a lower rate locked in thanks to an agreement in principle with their lender. As such, the actual rate on new borrowing is rising but yet to overtake the rate on outstanding balances – though tomorrow's (1/7) data from the Bank of England could mark this key turning point.

As mortgage rates rise, the question is what will happen to loan-to-income ratios (LTIs). If lenders maintain existing LTIs then new buyers should still be able to meet the price expectations of sellers – albeit at the cost of higher repayments or longer mortgage terms. However, if lenders reduce LTIs, then we could see a stand-off develop between sellers' price expectations and buyers' more constrained budgets.

In the event of a stand-off, we might end up with a stagnating housing market. Lower housing market activity might be more economically appealing than a house price correction but it is not without risk. A stagnating market could have massive secondary effects on the economy that contribute to a recession and eventual price crash anyway. It's not just those businesses directly involved in the house buying process that would suffer but all the other associated spending that comes with buying a home like fitting a new kitchen or buying furniture.

Fig 2: Average Quoted Mortgage Rates by LTV
Source: Bank of England

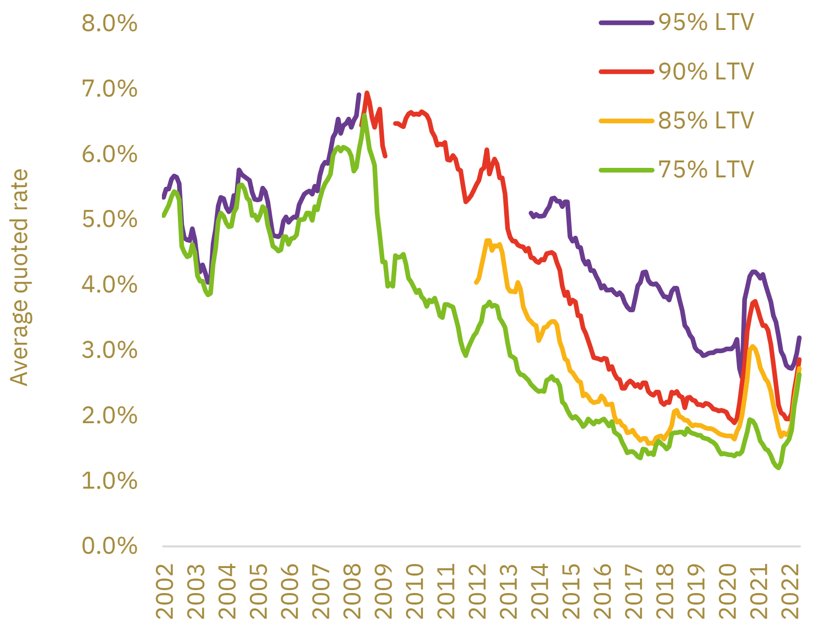
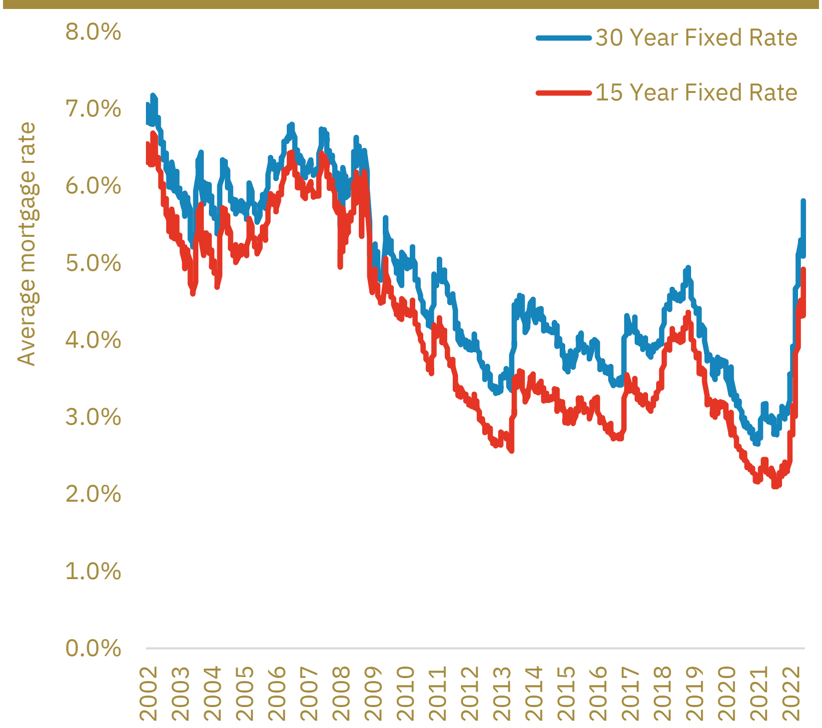


Fig 3: U.S. Average Mortgage Rate
Source: Freddie Mac



Still Not So Special

Back in April 2021 we highlighted that the UK was not unique in experiencing a housing market boom. Now some of those previously booming international housing markets are flashing red warning signals that should not be ignored by those focussed on the UK market. For example, average mortgage rates in the US are rising rapidly, with the 30 year fixed rate hitting its highest rate since November 2008 according to Freddie Mac (Figure 3). At 5.81%, this was nearly double the rate recorded this time last year.

Meanwhile the Canadian Real Estate Association (CREA) reported falling home sales in May and house prices, while still rising year on year, have now fallen for two months in a row. New Zealand recorded the fastest rising house prices back in April 2021 but the Real Estate Institute of New Zealand (REINZ) index reported(PDF) house prices in May were 7.7% lower than their peak in November 2021. Median prices in Auckland have fallen 13.5% over the same period.

Once Every Ten Years

This week ONS published the first major data release from the 2021 Census for England & Wales. It shows the usual resident population of England & Wales on the 21st March 2021 was 59,597,300 people, an increase of 6.3% over the previous ten years. The Census is a fantastic resource of detailed information, with much more data due to be released in coming months and years. However, the 2021 Census took place during a national lockdown in the middle of a global pandemic. This makes it very difficult to assess which results were longer-term trends (including the impact of Brexit) and which were short-term reactions to the pandemic. And some of these short-term reactions could have long-term implications for policy, be it housing, health, education or any other area that relies to Census data for robust data. Perhaps the Census should've been delayed till 2022 like in Scotland.

Lots of people have already jumped on the results of the 2021 Census as evidence for their preferred housing crisis narrative. Some have highlighted the increase in average household size (from 2.40 to 2.41 in England) as evidence for a lack of housing supply while others have touted the growing excess of dwellings relative to households (from 913,000 to 1,437,000 in England) as evidence that there is no lack of supply. The reality is likely to be much more complicated. The number of dwellings recorded by DLUHC will be revised in light of the census while disaggregating the effects of the pandemic from long-term trends will take time and more data.

Fig 4: Change in Population Compared to Change in Dwellings by Local Authority
Source: ONS, Census, DLUHC – England & Wales

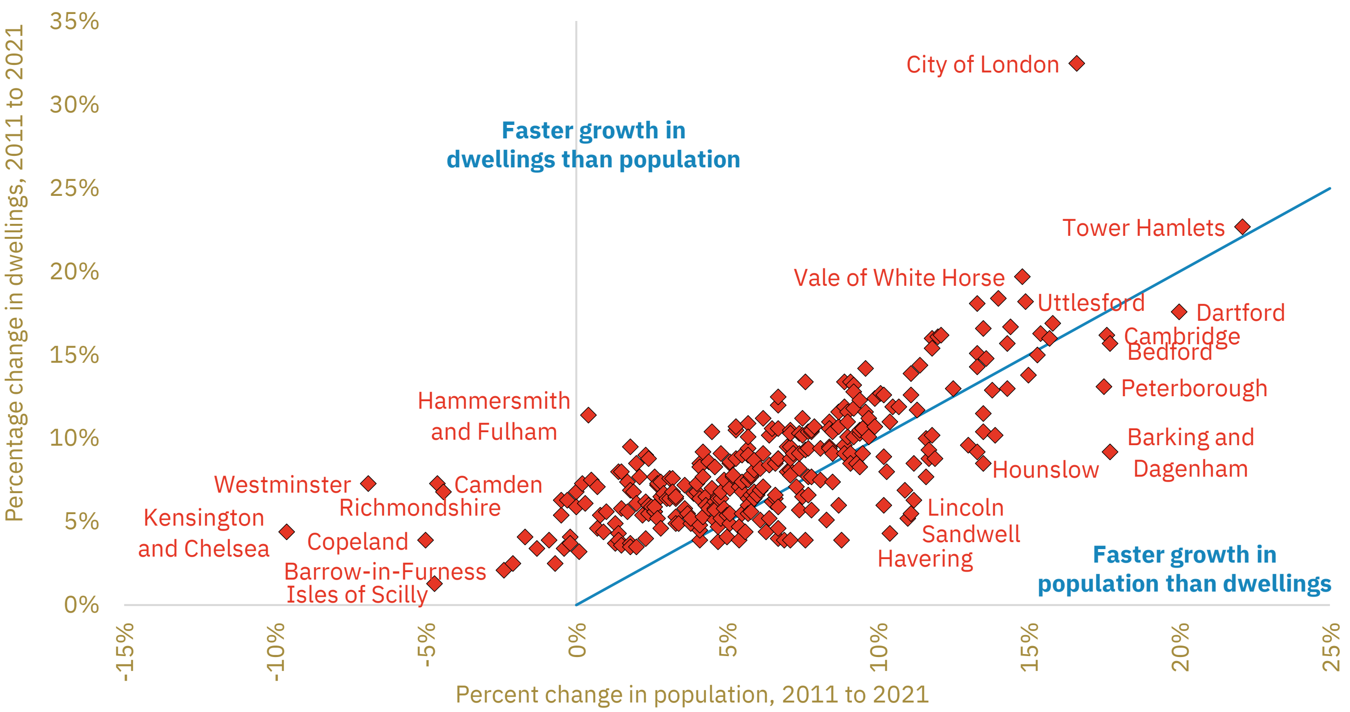
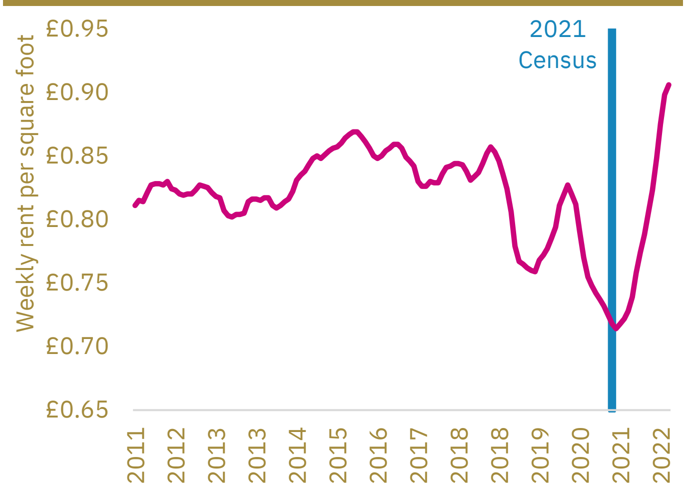


Fig 5: Weekly Rents in Prime London
Source: LonRes – Six Month Rolling Average



Perhaps the most extreme results are found in central London boroughs. At first glance, it appears the hollowing out of central London has extended beyond Kensington & Chelsea to other central London boroughs. As Figure 4 shows, the population fell in some boroughs despite an increase in housing stock over the ten-year period. This might suggest a big increase in empty and second homes – a reasonable assumption for that market. However, as data from LonRes in Figure 5 shows, the Census took place at the pandemic's trough in average rents recorded across top-end "prime" residential properties. Rents had fallen across central London as demand collapsed but they have since bounced back above their pre-pandemic level, suggesting a rebound in housing demand and population. It's quite likely that some of these boroughs now have higher populations than recorded in 2011.

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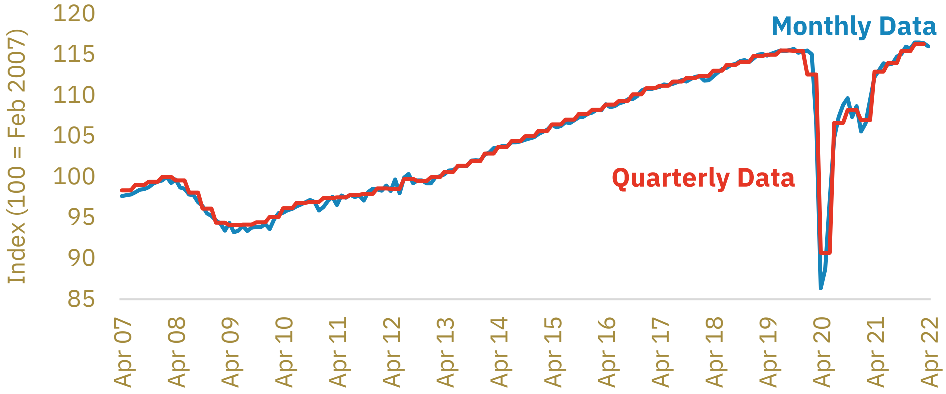
Market At A Glance

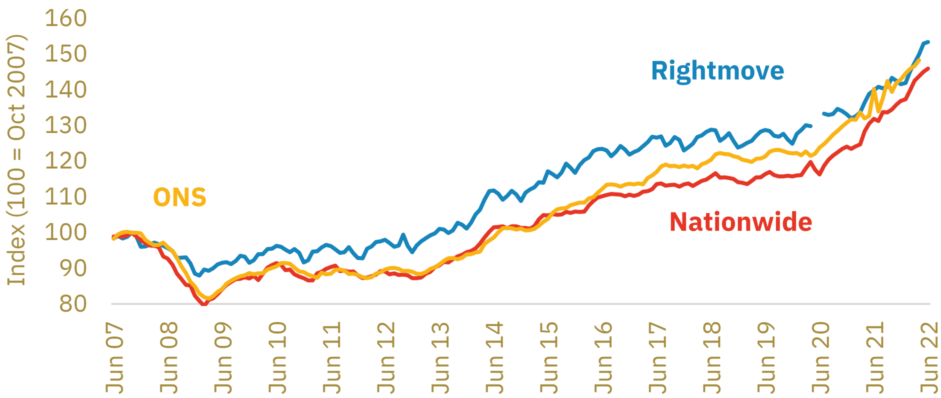
Economy - UK

The ONS monthly estimates reported GDP was 3.4% higher in April 2022 than the same month in 2021. This left monthly GDP just 0.4% higher than the pre-pandemic peak recorded in January 2020. However, this data will inevitably be revised in coming months and years.



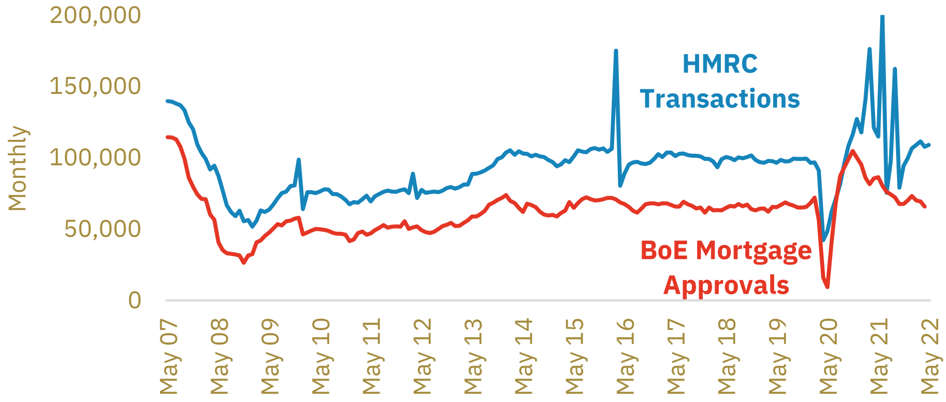
House Prices - UK

Rightmove reported a 9.7% annual rise in asking house prices in June 2022 while Nationwide reported a 10.7% annual rise in their mortgage approval based index for the same period. Meanwhile, the ONS reported 12.4% annual growth in its sales agreed index for the year to April 2022.



Transactions – UK

HMRC provisionally reported 109,200 residential transactions in May. This was 13.2% higher than the same month in 2019. Meanwhile, the Bank of England reported mortgage approvals for house purchase were just 0.3% higher in April 2022 than the same month in 2019.



New Supply - England

The latest net additions data for 2020/21 reported a 216,490 net new homes in England with 194,000 new build completions. The latest quarterly house-building data suggests there were 214,000 completions in 2020/21 while there were 238,500 new build Energy Performance Certificates in the year to Q1 2022 – a leading indicator for net housing supply.